STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Bell Telephone Company	)	
	)	98-0252
Application for Review of Alternative Regulation Plan	)	
	)	
Illinois Belle Telephone Company	)	
	)	98-0335
Petition to rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates.	)	(cons.)
	)	
Citizens Utility Board and The People of the State of Illinois -vs- Illinois Bell Telephone Company	)	
	)	00-0764
Verified Complaint for a Reduction in Illinois Bell Telephone Company's Rates and Other Relief.	)	

REPLY TO BRIEFS ON EXCEPTIONS OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

DAVID L. NIXON
MATTHEW L. HARVEY
SEAN R. BRADY
Office of General Counsel
Illinois Commerce Commission
160 North LaSalle Street
Suite C-800
Chicago, Illinois 60601
(312) 793-2877

Counsel for the Staff of the
Illinois Commerce Commission

June 25, 2001

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Relief.	)	

REPLY TO BRIEFS ON EXCEPTIONS OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

Now Comes the Staff of the Illinois Commerce Commission (“Staff”), by and through its counsel, and pursuant to Section 200.830 of the Commission’s Rules of Practice (83 Ill.Adm. Code 200.830), and the direction of the Hearing Examiners, respectfully submits this Reply Brief on Exceptions to the Hearing Examiner’s Proposed Order (“HEPO”) issued May 14, 2001.

The HEPO is well reasoned and carefully balances the interests of consumers, producers and competitors. The Hearing Examiners understand the positions of the various parties, and have accurately summarized the arguments of these parties, and have reached the correct decision in the vast majority of cases. Staff's own Brief on Exceptions recommended a relatively few amendments to the HEPO.

Briefs on Exceptions ("BOEs") were also submitted by Ameritech Illinois ("Ameritech" or "Company"), AT&T Communications of Illinois, Inc., McLeodUSA Telecommunications Services, Inc., the United State Department of Defense and All Other Federal Executive Agencies, and jointly by the City of Chicago, Citizens Utility Board, People of the State of Illinois and Cook County State's Attorney (collectively, "GCI/City").

For purposes of making its responsive points in this Reply Brief on Exceptions, Staff has focused on the BOEs submitted by Ameritech and GCI/City. Responses will be set forth in an order that follows the delineation of issues presented in the HEPO. Also, issues will be identified by heading number and title as denoted in the HEPO.

III. THE STATUTORY CRITERIA AND GOALS

1. Has The Plan Produces Fair, Just, And Reasonable Rates

Staff objects to Ameritech's assertion at page 9 of the Company's BOE that "the uncontroverted evidence in this record is that Ameritech Illinois' noncompetitive services earned only 5.55% in 1999," and to its reference to Staff Ex. 11.0, page 32, as supposed Staff support for this statement. The Staff Exhibit cited contains no reference to this calculation. In fact, Staff disagreed with this calculation in its testimony (Staff Ex. 4.0, p 6), and in its Reply Brief (page 29) in this docket. An accurate summary of Staff's position is that it is inappropriate to calculate separate returns for competitive and non-competitive services, and that there is no acceptable methodology for doing so. None of Ameritech's wording changes to the language of this section of the HEPO, as proposed at pages 6 and 7 of the Company's Exceptions, should be accepted. Staff supports this portion of the HEPO as written.

IV. RATE RE-BALANCING

In its Brief on Exceptions in this proceeding, Ameritech has withdrawn its rate re-balancing proposal. (Ameritech BOE, page 41.) However, despite this withdrawal, Ameritech desires that certain findings be made with respect to its LFAM model. (Id.) However, these arguments are unavailing, as the HEPO was correct in determining that the LFAM model is deficient. The record in this case contains ample evidence that the LFAM model Ameritech used to calculate LRSIC does not conform to the Commission's cost of service rules contained in 83 Illinois Administrative Code Part 791. (Staff Brief, page 121.) The HEPO also correctly determines that the LFAM model's deficiencies meant that Ameritech did not meet the burden of proof necessary to justify its rate rebalancing proposal.

First, the HEPO correctly determines that the LFAM model does not comply with the cost-of -service rules, <u>see</u>, generally, 83 Ill. Admin. Code 791, and appropriately rejects Ameritech's LFAM cost study on, *inter alia*, that basis.

Staff witness Marshall testified that the LFAM model does not comply with the cost of service rules because it does not reflect planned adjustments in the firm's plant and equipment. Section 791.40(1) provides that a LRSIC study shall be based upon the locations of, and planned locational changes to, the existing network configuration. (83 Ill. Admin. Code 791.40(1).) As noted in Mr. Palmer's direct testimony, Ameritech Ex. 10.0 at 8, the LFAM model re-designs the Company's entire distribution system incorporating a purely hypothetical system. Ameritech provides no evidence that this hypothetical system reflects only planned adjustments to plant and equipment or is based on the existing network configuration as required by the rule. (Staff Ex. 18.0 page 5 - 6.)

Section 791.40 requires that a LRSIC study reflect the demand for the entire service that is affected by the business or regulatory decision at hand. If the LRSIC study is for a new service, the study shall include all demand forecasts used in the computations. This section of the rule requires that the demand utilized to calculate the capacity included in the LRSIC study must also be used to allocate the costs of that capacity. Ameritech has modified its LRSIC methodology, AI Ex. 10.1, pages 43-44, so that it is no longer in compliance with Staff's interpretation of this rule. (ICC Staff Ex. 18.0, page 6.)

Finally, Section 791.20 provides the definition of usable capacity discussed above. Mr. Palmer concedes that the effective fill for drop and fiber feeder cable is significantly less than the 85% fill factor calculated in compliance with Part 791. (ICC Staff Ex. 18.0, page 6.) In addition to failing to satisfy existing cost-of-service rules, the LFAM model also fails to work properly. Ameritech has described an extensive list of assumptions purporting to demonstrate how the LFAM model is superior to Ameritech's previous cost modeling tools. (Ameritech BOE, pages 41 - 65.) As described in Staff's testimony, see, Staff Ex. 28.0 at 2, Staff retained a consultant and undertook to test these assumptions. The consultant encountered numerous problems in running the model, the most important of which was the failure of the GUI interface to update the database. Ameritech acknowledges that this problem exists, and that the problem resulted in neither Staff nor its consultant being able to utilize the model for sensitivity analyses. A model that can be operated only with manual inputs by Ameritech technicians is subject to manipulation and should not be approved by the Commission.

In its Exceptions, Ameritech minimizes this GUI problem and contends this problem has nothing to do with the underlying model itself. (Ameritech Exceptions, page 12.) However, the salient fact is that the model failed to work when the consultant attempted to run sensitivities. (Staff Ex. 28.0, page 2.) This fact indicates that, notwithstanding Ameritech's assertions regarding the LFAM model, it is unreliable. The fact that Ameritech has expended a great deal of time, effort, and money to develop the model is irrelevant if the model does not work properly when tested. Ameritech is, in effect, attempting to use a sort of "defense contractor" argument here, suggesting that a poorly designed system, that fails when its effectiveness is tested, should nonetheless be adopted because, were it not, all of the money invested in it would be wasted. The HEPO rightly rejected this argument, as should the Commission.

It is therefore entirely appropriate for the HEPO to conclude that the LFAM model is deficient. The model failed the requirement of allowing other parties to replicate Ameritech's results. This was particularly important in light of the extraordinary increases in network access line LRSICs generated by the new model. When a model fails to perform a basic task such as being able to update a critical assumption such as the fiber break length, the Commission is entitled to conclude there are other errors that contribute to the extraordinary increases in network access line LRSICs. Access to the network is the most fundamental aspect of residential phone service. It is difficult to believe that AI's previous modeling efforts were so deficient as to underestimate costs by over 50%. Ameritech, in effect, asks the Commission to believe that it has, apparently for years, grossly underestimated and under-recovered its loop costs, but has now developed a model for "properly" recovering such costs, which, by a delightful coincidence, comes to light at precisely the same time as its rate rebalancing proposal. The skepticism expressed by the examiners in the HEPO is well founded.

Ameritech also contends that since parties did not refute each individual statement made by Mr. Palmer in his surrebuttal testimony, the Commission should accept them as a matter of record. (Ameritech BOE, pages 51 - 52.) This, however, is unconvincing. First, the schedule in this proceeding required parties to file surrebuttal testimony on the same date. Therefore, there was not another round of testimony for Staff or other parties in which Mr. Palmer's statements could be rebutted. In other words, Ameritech asks the Commission to base its findings upon the testimonial schedule, rather than on the substance of the record.

Second, since the LFAM model failed the primary test of actually working properly, an exhaustive analysis of each point listed by Mr. Palmer is scarcely necessary. If Ameritech presented unrebutted testimony that automobiles will run properly if their gas tanks are filled with Gatorade, or that Styrofoam is an excellent source of vitamin C, the Commission would nonetheless properly reject those propositions, as they can readily be disproved by testing. Mr. Palmer's testimony is on an identical footing. He asserts that the model works, but it could not, when tested, be made to work. The model in question could not be run by either Staff or its consultant, even though the system used was furnished by Ameritech, was used on Ameritech's premises, and Ameritech's procedures (as well as company experts) were utilized by Staff and the consultant in an attempt to process data. In other words, Mr. Palmer's testimony is contrary to the facts, as they are observed from actual tests upon the LFAM model. Accordingly, rebuttal of Mr. Palmer's testimony is not needed.

Accordingly, the Staff recommends the following changes be made to the HEPO. On page 84, paragraph 1:

> ~~The Commission concludes that the rate re-balancing proposal of AI must be rejected in its entirety at this time.~~ During the Briefs on Exceptions phase of this proceeding, AI withdrew its rate re-balancing proposal. However, we are not of the opinion that this prevents us from noting that, had it not been for Ameritech's eleventh-hour concession, we would have rejected the proposal in its entirety. The evidence submitted by Ameritech in support of its proposal, which relies heavily upon cost studies produced by its LFAM model, is unconvincing, and, indeed, suspect. In fact, the evidence adduced in this case compels us to reject the use of the LFAM model, at least as it is currently configured, to develop LRSIC costs for use in compliance and other matters before this Commission.
>
> Despite AI's protestations to the contrary, Staff and City fully set forth several deficiencies with the LFAM. Particularly troubling is the LFAM's lack of compliance with part 791 of the Administrative

> Code. Also troubling is the apparent programming flaws detected by Staff and City. We note City lists no less than seven deficiencies with AI's LFAM.
>
> What is telling about the new model's reliability or lack thereof is the significant change in costs resulting from the use of the 2000 Aggregate Test. Both tests were done within just a few months of one another. AI would have the Commission believe that it's model used in the 2000 Aggregate Test was so deficient that it failed to capture up to 1/3rd of the total actual costs for network access lines. To say the least, the Commission is skeptical of the LFAM's ability to find never before found costs. Further, the Commission rejects the LFAM model to the extent that it fails to comply with the requirements of Part 791. Staff correctly points out that this Commission has never approved a cost study generated by, or costs derived from the LFAM model nor do we choose to today. ~~Ultimately, AI has failed to meet its burden in convincing the Commission that its costs for network access lines are above LRSIC~~. Accordingly, we reject the use of LFAM to determine LRSIC costs. ~~For that reason, the Commission rejects AI's rate re-balancing proposal.~~

AI's proposed language changes to the HEPO should be rejected in their entirety.

V. GOING FORWARD

B. Proposed Modifications to the Price Cap Index

2 X Factor

In their respective BOEs, Ameritech Illinois (at pages 14 - 15) and GCI/City (at pages 31 - 33) continue their arguments previously put forth in their testimony, briefs and reply briefs regarding the X factor. The HEPO, however, correctly analyzed this issue. The Commission, therefore, should reject both of these parties' suggested changes and retain the current language in the proposed order regarding the "X" factor.

GCI/CITY Higher X Factor

GCI/City continue to contend that the X factor should be 6.5% rather than the 4.3% the HEPO properly decided it should be. GCI/City maintain that the Commission should adopt the FCC 6.5% X factor. However, as they have throughout the proceedings, GCI/City failed to address the many methodological shortcomings that Staff and Ameritech established are associated with the FCC's analyses that form the basis for a 6.5% X factor. This failure was a significant aspect of the HEPO's conclusion to reject the GCI/City position. (HEPO, pages 78 – 79; "Commission Analysis and Conclusions" first paragraph.)

GCI/City also contend that a higher X factor is justified because of the high level of earnings Ameritech enjoyed under alternative regulation. This argument is faulty because it fails to recognize that Ameritech's "high level" of earnings was not caused by an X factor that was too low for non-competitive services. Rather, the high earnings were a result of the Company's actions of declaring services competitive when effective competition really did not exist, and raising prices accordingly, without any concomitant offsetting reduction in prices of non-competitive services. No changes should be made to the HEPO based on this argument.

V. B. 2. b. Consumer Dividend

Ameritech continues to assert that the 1% consumer dividend included in the X factor should be eliminated. As the HEPO correctly noted (in the second to last paragraph under "Commission Analysis and Conclusions"), this would contravene section 13-506.1(b) of the Telecom act, which states that any alternative regulation plan must identify how ratepayers will benefit from any efficiency gains arising out of regulatory change. Apparently, Ameritech wants to reserve all the efficiency gains arising out of regulatory change to itself. The HEPO appropriately rejects this type of result and should not be modified as suggested by Ameritech.

Ameritech fronts an additional argument for changing the X Factor that is also unpersuasive. The Company posits that there were considerable uncertainties associated with the establishment of alternative regulation when the Plan was established which justified the inclusion of the consumer dividend. The Company suggests that these uncertainties have now disappeared, and the consumer dividend should disappear, as well. Staff agrees it is true that some of the uncertainties have disappeared. But, in contravention of Ameritech's position, one of the things we have learned is it certain that Ameritech can perform well financially under an X factor that includes a 1% consumer dividend. The consumer dividend should remain a part of the X Factor.

B. 3. Z Factor

GCI/CITY

GCI/City maintain that the Z factor adopted in Docket No. 92-0448/93-0239 should not be changed. They argue that the 30 day period proposed by Staff for review of exogenous change filings, and adopted by the HEPO, is too short to test the validity of the demand assumptions. GCI/City further argue that allowing automatic offsets for all Commission mandated rate changes would circumvent the Commission's discretion to determine whether the price regulation formula is just and reasonable absent the offset. GCI/City would have the Commission reject these proposals found to be appropriate by the Hearing Examiners. (GCI/City BOE, pages 33 – 34; Exceptions, pages 73 – 75.)

For the most part, GCI/City has merely repeated the arguments already rejected by the Hearing Examiners. In addition, Staff believes GCI/City's concern regarding the HEPO's purported allowance of automatic adjustments. Staff believes the HEPO's intent is not to permit automatic adjustments, and that the HEPO's language is sufficient to communicate this conclusion:

> If AI claims an event has occurred which it feels requires exogenous treatment, AI must satisfy the four criteria as set out in the Order at 62, regardless of whether such an event was a result of a Commission mandated rate reduction or otherwise. (Emphasis added.)
> (HEPO, V B 3 "Commission Analysis and Conclusion," second paragraph.)

AMERITECH

Ameritech takes exception to the HEPO's summary of its proposal regarding exogenous change treatment of Commission-mandated reduction (Section V B 3) on the grounds that it is incomplete. The Company suggests that two paragraphs be inserted following the subsection entitled "AT&T's Position" to remedy this concern. (Ameritech Exceptions page 19, Exception 25.). Staff agrees that the Order would be more complete if the two paragraphs proposed by Ameritech were added.

C. Pricing Flexibility

Staff fully concurs in the HEPO's conclusions and findings on the issue of pricing flexibility. The HEPO is correct on this issue and does not need to be changed. Ameritech's arguments concerning pricing flexibility are unconvincing, and should be rejected. Ameritech contends that the HEPO reflects a misunderstanding of its arguments concerning the Pricing Flexibility issue. (Ameritech BOE, pages 15 - 18.) In particular, Ameritech points to the "Commission Analysis and Conclusion" portion of Section V, C, of the HEPO that states "[t]here is little or no evidence indicating A[meritech]'s non-competitive services have suffered market share losses or that it has been unable to respond to market forces" as the basis for its exceptions. (Ameritech BOE, page 16.) However, the fact that the HEPO finds Ameritech's case to be lacking does not mean that there was a misunderstanding of Ameritech's arguments; here, it means that the HEPO understood them perfectly well. The conclusions in the HEPO reflect appropriate judgments made by the Examiners based on a preponderance of the evidence in the case.

Ameritech's arguments offer no new perspective on this issue. Ameritech's BOE consists of a reprise of arguments presented in its prior briefs. The HEPO is correct in describing Ameritech's position as asserting that it needs to have increased pricing flexibility in order to meet the demands of the marketplace. Additionally, Ameritech's case was, and still is, based on trying to convince the decision makers that not allowing increased pricing flexibility is akin to enforcing a rate freeze in perpetuity. (Ameritech BOE, pages 15, 18.) That conclusion, of course, is erroneous. (Staff Brief, pages 40, 41.) Any reading of the HEPO demonstrates that these arguments were clearly understood, and properly rejected, by the Examiners. (HEPO, at 82, 83; Section V. C. Pricing Flexibility.)

It is apparent from the Hearing Examiners' analysis that Ameritech failed to provide any compelling arguments concerning this issue. The HEPO's conclusions regarding pricing flexibility are appropriate and should not be changed.

D. Proposed New Component Merger Related Savings/M Factor

AMERITECH

Staff addressed its difference in the year when the permanent, going-forward level of net merger savings will be reached in its Brief on Exceptions and will this position is unchanged. Staff disagrees with Ameritech that a final computation of net merger savings should be made based upon actual 2002 results. This is especially inappropriate because Ameritech has experienced delays in implementing planned merger savings initiatives. (Staff Ex. 18.0, pages 8 - 9) The language modification proposed at page 20 of the Company's Exceptions should not be adopted.

GCI/CITY

GCI addresses its proposed merger savings M factor at pages 40 - 42 of its BOE. Staff also proposed the adoption of an M factor, but only as an alternative to its main position. (Staff Reply Brief, pages 31 – 35.) Staff wishes to clarify that both the M factor it proposed and the M factor GCI proposed are properly applied as a one-time permanent adjustment to reflect net merger savings. Once the PCI has been adjusted for the going forward level of net merger related savings, the reduced PCI will cause a similar recognition of net merger related savings in each following year. Therefore, the M factor will only apply to annual filings on a going forward basis if the Commission makes further adjustments to the annual amount of net merger savings, perhaps as a result of an audit or a future merger.

Staff proposed a one-time adjustment of $81 million; GCI/City's proposed adjustment is $349 million. Stated in terms of percentages, Staff's proposed M factor is 1.114%, and GCI/City's proposed M factor is 4.8%. Staff does not agree with the "transfer ratio" methodology employed by GCI to calculate its proposed M factor and therefore, does not recommend any of the language changes proposed by GCI at pages 85 - 87 of its Exceptions. The HEPO should be modified as proposed in Staff's BOE, at pages 27 - 29.[1]

E. Baskets

Staff observed in its BOE that the HEPO must be altered to reflect the effect of the new telecommunications bill upon basket structure. (Staff BOE, page 35.) Particularly, Staff notes that the Business basket should be eliminated from the plan because the legislation declares all business services as competitive. (HB 2900, Section 13-502(b).) Ameritech is in agreement with

[1] Staff's BOE, at page 29, provides a date of 2005 for the one-time adjustment. This date should be amended to 2006.

Staff's interpretation of the new legislation; the Company also states that the Business basket would be eliminated. (Ameritech BOE, page 20.)

However, Ameritech also inappropriately tries to use the new legislation as a basis for declaring that the remaining three baskets should be consolidated. The new statutory language, assuming it becomes law does not support any such conclusion. There is no evidence whatever that the General Assembly intended to require consolidation of the basket structure. Indeed, it is clear from HB 2900 that the General Assembly placed primary importance upon the protection of residential ratepayers. It requires companies subject to alternative regulation to offer several integrated packages of services, to be classified as noncompetitive, and which are intended to provide savings to customers. (HB 2900, Senate Amendment 3, new Section 13-518.) It imposes stringent new service quality requirements upon providers of residential local service. (HB 2900, Senate Amendment 3, new Section 13-712.) And it requires such providers to compensate customers and provide alternative service when those standards are not met. (Id.) It imposes strict new slamming and cramming prohibitions. (HB 2900, Senate Amendment 3, new Sections 13-902, 13-903.) In short, the new legislation is a real quantum leap forward in the cause of protecting captive customers. The notion that the General Assembly intended the new legislation to be advanced in support of consolidation of baskets – at the expense of residential ratepayers, who would undoubtedly suffer if this proposal were adopted – is simply absurd.

Ameritech's argument utterly fails to address, or even accept, the continuing need of the remaining customer classes for a measure of protection in the Plan. The HEPO is correct in concluding that all customer classes will continue to need to be protected from discrimination and cross subsidies. (HEPO, page 92, V. E. c. Commission Analysis and Conclusion.) The elimination of the Business basket does not mitigate the need that the remaining captive customers have for protection from oppressive practices. Ameritech's BOE provides no compelling argument that the negative consequences of additional basket consolidation are somehow vitiated by the legislative removal of the Business basket.

Ameritech further argues that the new service packages the legislation requires it to provide are evidence that the legislature views vertical services as basic services. (Ameritech BOE, page 21; HB 2900, Section 13-518(a).) On this basis, AI argues that, at a minimum, it is proper to merge the Other basket with the Residential basket. However, a simple reading of the bill's provisions demonstrates that this argument is disingenuous – almost gallingly so, in fact. The section of the new bill requiring that Ameritech provide such packages is titled "Optional service packages." (See, HB 2900, Senate Amendment 3, new Section 13-518.) Ameritech, having argued stridently throughout this proceeding that calling plans are optional services, and that optional services are properly assigned to the "Other" basket, now argues that a group of bundled services specifically described by the General Assembly as "optional" should be assigned to a consolidated Residential basket. It is difficult to see how this argument can be seriously advanced.

In fact, packaging vertical services with access lines and usage does nothing to change the discretionary – indeed, optional – nature of vertical services, as the General Assembly made clear. Ameritech's argument, although creative, does not logically follow from the applicable legislative language that clearly states that the packages provided by Ameritech will be optional. (Id.) If the General Assembly desired to change the vertical services from discretionary, or optional, type services, to basic services, it would have included vertical services in the budget package as well as the "flat rate" and "enhanced flat rate package

Finally, the General Assembly clearly intended that the local service packages Ameritech is required to offer under Section 13-518 be offered "at prices that will result in savings for the average consumer." (HB 2900, Senate Amendment 3, new Section 13-518.) Ameritech appears to have concluded that raising basic rates is the most efficient way to insure savings over basic rates to customers who decide to take the optional packages. This, however, is clearly not what the General Assembly intended. Ameritech's arguments concerning the merging of these two baskets should therefore be summarily rejected.

For the above stated reasons, Staff's recommendations concerning this section of the HEPO remains unchanged from our position in its BOE. (Staff BOE, Exception 21, pages 36 – 37.)

G. Monitoring And Reporting

Staff supports the HEPO as written and disagrees with Ameritech's arguments concerning any reduction in the amount of information required to be reported on an annual basis. (Ameritech BOE, page 27 and Ameritech Exceptions, pages 24 – 25.) Staff's position on this issue is fully discussed in its Initial Brief, at pages 51 – 52, and its Reply Brief, at pages 30 - 31. It is particularly important that earnings information continue to be reported so that this information is available to all interested parties. To the extent that any information may be duplicated through the filing requirements, it is less of a burden on the Company to accomplish these filings than it would be on the Commission to search through them to locate the information. Therefore, the HEPO correctly determines that Ameritech's concern regarding the possible duplication of some filings is outweighed by the substantive and administrative necessity for the filings.

VI. Rate Re-initialization

Both GCI/City (BOE, pages 45 – 58) and Ameritech (Exceptions, pages 25 –26, Exception 35) suggest changes to the HEPO concerning its conclusions with respect to rate re-initialization. Both parties use faulty and inconsistent logic to support their proposed amendments and the Commission should consequently reject these modifications outright. However, to the extent that the Commission elects to reinintialize or otherwise reduce rates, it should do so in a manner consistent with the Staff's, rather than GCI's, or Ameritech's proposals.

GCI/CITY

GCI/City argues that the issue of fair, just and reasonable rates cannot be addressed without factoring in Ameritech's earnings under the alternative plan, further argues and the Plan must produce rates and earnings that fairly balance ratepayer and shareholder interests. GCI/City further contends that that the HEPO should conclude rate re-initialization is necessary because AI's earnings have been and are outside the zone of reasonableness. GCI/City ultimately concludes that rates must be reduced by $956 million to return them to just and reasonable levels, consistent with the cost of capital.

As noted previously by Staff, GCI/City fails – yet again – to grasp the fundamental principle of price regulation: under price regulation, the Commission looks to the regulated company's price performance and not its earnings performance to determine whether rates are just and reasonable. Under price regulation, consumers receive a guarantee that their prices will rise less than the rate of general inflation, and the regulated company gets the opportunity to earn higher returns. If Ameritech does then indeed earn higher returns this should not be interpreted as a failure of the plan, but recognized as one of the anticipated possible outcomes.

GCI opines that, with respect to its findings that rates ought not to be reinintialized, the HEPO "misses the forest for the trees." Staff cautions against the use of this metaphor in Commission practice, see, e.g., Ameritech Brief on Exceptions, ICC Docket No. 98-0860, but nonetheless offers another one: GCI puts the cart some miles in front of the horse.

Specifically, GCI complains that the HEPO fails to address the extensive evidence it submitted regarding Ameritech's proper rate of return[2]. However, this is not an error in any sense. The HEPO found, correctly, that rates ought not to be reinitialized, and further found that Ameritech ought not to be regulated subject to rate of return principles. Accordingly, having determined – again, correctly – that Ameritech's earnings have not exceeded the Staff's recommended "zone of reasonableness," the HEPO declined to reach rate of return issues, precisely because there was no need for it to do so. Given the fact that the HEPO neither reinintializes rate, or orders the company returned to rate of return regulation, the GCI rate-of-return case – and the Staff's and Ameritech's – has been rendered moot, and ruling upon specific rate of return issues is no more necessary to the resolution of this case than rulings on any other irrelevant issue.

In fact, GCI, while describing the HEPO's refusal to rule on rate-case issues as "incomprehensible," behaves incomprehensibly itself. It argues that the HEPO is defective because it failed to rule upon issues that GCI *lost*, as if GCI had in fact *won* them. This is truly incomprehensible; it is as if a civil plaintiff, having had his case dismissed, demands a ruling on damages, or a

[2] The HEPO similarly failed to address the Staff's far more extensive – and considerably more robust – evidence regarding Ameritech's proper rate of return. It should not be forgotten that the Staff has, since the outset of this case, taken the laboring oar in developing a rate-of-return analysis. Staff has presented a careful, detailed and disinterested analysis of rate-of-return issues, in contrast to those presented by GCI and Ameritech, which are compromised by those parties' agendas of seeking to justify rate cuts and increases respectively. Consequently, to the extent that the Commission elects to reduce or reinintialize rates, Staff's analysis should form the basis for the Commission's decision.

prosecutor, confronted with a “not guilty” verdict, argues that the judge should impose a sentence

With respect to the zone of earnings reasonableness, it is inappropriate for subscribers of non-competitive services to share in the rewards that occur on the competitive side, precisely because such subscribers are insulated from the risks associated with competition. If Ameritech is doing well on the competitive side of the business, subscribers to non-competitive services should not get a rate cut in order to reduce the company’s earnings to its cost of capital. Similarly, if Ameritech is doing poorly on the competitive side of the business, rates for subscribers to non-competitive services should not be increased in order to make the Company’s earnings whole.

According to Ameritech, its earnings on the non-competitive side of the business are below its cost of capital. Under GCI’s logic, this would imply that AI’s non-competitive rates are too low to be just and reasonable to shareholders. Consequently, if the Commission were to employ GCI’s reasoning – and accept Ameritech’s assertions regarding non-competitive earnings – it should order a rate <u>increase</u> for non-competitive services to bring them back to just and reasonable levels[3]. It is certain that GCI would soundly reject any such outcome. This, however, illustrates the logical bankruptcy of GCI’s position. It appears to accept rate reinitialization only to the extent that rates would be reduced; indeed, it appears willing to advance *any* position that would, if adopted, result in rate reductions.

If GCI is arguing that the prices of services that are declared as competitive have been too high, it is not alone. The newly adopted Illinois Telecommunications Act[4] recognizes that this may have occurred and has ordered refunds for consumers affected. However, the Act does not propose that the rates of these services be re-initialized because of high earnings. Neither should the Commission.

AMERITECH

Ameritech argues in its Exceptions (AI Exception No. 35) that the Commission should not evaluate rate re-initialization relative to a zone of earnings reasonableness. However, at the same time, Ameritech "recognizes Staff's view that it might seek relief if its earnings fall below a level which the Company finds acceptable and/or which allows it to fulfill its obligations to consumers in this state." (Ameritech BOE, page 7.) . In other words, Ameritech cheerfully argues that it should reap the benefits of competition, but should be insulated from the discipline of the market if it fails to compete successfully. Consequently, AI's proposal to delete two lines of the Conclusions regarding rate re-initialization should be denied.

Rate Design

The HEPO correctly finds that rates should not be reinitialized. The Staff concurs fully in this finding, and stresses that it does not advocate

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[3] Staff does not recommend such a course of action.

[4] Governor Ryan is scheduled to sign the bill into law shortly after the due date of this Reply to Briefs on Exceptions.

reinitialization. However, to the extent that GCI has raised certain specific issues pendent to reinitialization, Staff will address them here.

In its Reply Brief, GCI/City continues to advocate rate reinitialization and proposes a rate design to adopt should the Commission elect to adopt GCI/City's proposed revenue requirement reductions. (GCI/City BOE Appendix.)

Should the Commission elect to order that rates be reinitialized, the GCI/City rate design proposal should not be adopted. GCI/City proposes cutting rates on several services that are classified as competitive. (GCI/City BOE Appendix.) This is pointless and arguably unlawful. It is neither appropriate nor effective to reduce the rates for competitive services, since those rates can be raised on one days notice. (Staff Brief, page 124; <u>see</u>, also 220 ILCS 5/13-505.) Furthermore, even though GCI/City advocates ignoring the provisions of HB2900 arguing that the Governor has not yet signed the bill[5], GCI City BOE at 89, Staff is compelled to point out the aspects of GCI/City's proposals that would conflict with that bill when it is signed by the Governor and becomes law. First, the bill provides that for end users located in Ameritech's territory, services provided to business end users will be classified as competitive as soon as the bill goes into effect. This provision of the bill would further exacerbate the competitive service problem outlined above. Second, the bill provides for AI that residential vertical services other than caller identification and call waiting will be considered competitive services on June 1, 2003. Thus, even if the Commission adopted

[5] As the Governor is scheduled to sign the bill on June 28, this argument has been overtaken by events.

GCI/City's proposed rate reductions, Ameritech would be able to raise rates in 2003 for vertical services once they are declared competitive.

Given this set of circumstances, it would be difficult if not impossible to attain the level of revenue requirement reduction advocated by GCI/City, without forcing non-competitive rates below LRSIC, in violation of Illinois Cost of Service rules.

If the Commission elects to reinitialize or otherwise reduce rates, it should use the method proposed by Staff. (Staff Ex. 28.0, page 15.) Specifically, usage rates for basic non-competitive services should be reduced first, and then the usage rates in non-competitive calling plans, and finally non-competitive vertical services. However, rates for these services should not, in any case, be reduced to the point where they are below the LRSIC shown for the service in AI's 2000 Aggregate Revenue Test. Like the proposal set forth by GCI/City, most vertical services will become competitive services in 2003. Therefore, it would be difficult to maintain the level of revenue requirement reduction identified by Staff, let alone the reduction quantified by GCI/City.

Staff proposes no changes to any language in the HEPO on rate design issues. GCI/City's proposed changes should be rejected in their entirety.

B. Rate of Return Analysis

The Staff realizes that, the Commission may determine that re-initialization or rate reductions serve the public interest more optimally than the Staff's recommendation that rates not be re-initialized. Accordingly, Staff presented a well-supported case addressing rate-of-return issues in this proceeding. To the extent that the Commission determines that the public interest is best served by re-initialization, and to provide a complete record for the Commissioners, the Staff urges the Commission to adopt its recommended language set forth below. For a complete discussion of Staff's development of a revenue requirement, see Staff's Initial Brief at pages 82 through 128.

In its Brief on Exceptions, GCI/City emphasizes the use of 11.80% for return on equity. (GCI/City Exceptions Section IX.D - Commission Analysis and Conclusion, paras. 5,6). If rate of return is considered, it should be clarified that Staff does not support using the low end of its recommended return on equity range (which is what 11.80% is) for revenue requirement purposes in the event the Commission orders rate re-initialization. However, if the Commission decides to re-initialize AI's rates and accepts GCI's arguments that that the low end cost of equity should be 11.80%, Staff has no objection to the conclusion language proposed by GCI. (GCI Exceptions Section IX.D - Commission Analysis and Conclusion).

Finally, Staff proposes that the current Section VI be renumbered as Section VI.A, and that the summary of the revenue requirement be added as Section VI.B of the Order:

B. REVENUE REQUIREMENTS ANALYSIS

Staff and GCI prepared a revenue requirement analyses in this proceeding to provide the Commission with a complete record if the

Commission determines that it is appropriate either to re-initialize the rates of Ameritech or to return Ameritech to rate of return regulation. (Staff Ex. 5.0, lines 98-100.) AI presented information for a 1999 calendar year test year in testimony. GCI addressed the test year and proposed adjustments. The witnesses who addressed revenue requirement analysis were Mr. Timothy Dominak for Ameritech Illinois, Mr. Ralph C. Smith and William Dunkel for CGI, Mr. Bill L. Voss, Ms. Dianna Hathhorn, Ms. Mary H. Everson, Ms. Judith Marshall, and Mr. Bud Green for Staff of the Illinois Commerce Commission. AI witness Dominak presented AI's final proposed rate base and operating statement in his Additional Surrebuttal Testimony. (AI Ex. 7.3, Scheds. 1 & 2.) The witness who addressed the cost of capital were Dr. Roger Ibbotson and Dr. William Avera for AI, Mr. Ralph Smith for GCI, and Mr. Alan Pregozen for the Staff.

Staff recommended a test year intrastate revenue requirement of $2,218,230,000, which is a reduction of 27.41% from Ameritech's proposed revenue of $3,055,806,000. (Staff Ex. 5.0, Appendix A, page 1, and Ameritech Ex. 7.3, Sched. 1.) GCI review of the revenue requirement shows that Ameritech has an Illinois intrastate revenue excess of $956,000,000. (GCI/City Ex. 6.3, Sched. A Revised)

Staff recommended a rate base of $2,919,318,000, which is a $213,916,000 decrease from Ameritech's proposed rate base of $3,133,234,000. (Staff Ex. 5.0, Appendix A, page 4, and Ameritech Ex. 7.3, Sched. 2.)

Finally, Staff recommended a rate of return of 10.52%, which reflected a 13.1% common cost of equity. In determining the cost of capital, Staff analyzed the capital structure and cost of debt, and return on common equity.

The following sections summarize the record of Staff's and GCI's analyses.

1. Revenue & Expense Adjustments

AI witness Dominak presented AI's final proposed operating statement in Additional Surrebuttal Testimony. (AI Ex. 7.3, Sched. 2.) Staff and GCI proposed several adjustments to AI's operating statement, as discussed below.

a. Contested Issues

i. Interest Synchronization

Staff witness Voss proposed an interest synchronization adjustment to reflect the tax savings generated by the interest component of Ameritech's revenue requirement. (Staff Ex. 5.0 at 12, lines 203-05.) GCI also recommended an interest synchronization adjustment, calculated by applying the weighted cost of debt to the recommended rate base to obtain a synchronized interest deduction for use in the calculation of test year income tax expense. Ameritech opposed both adjustments claiming that interest synchronization is an inappropriate "estimate" of Ameritech's interest expense for the purpose of an alternative regulatory plan. (Ameritech Ex. 7.1 at 11.) The Commission has repeatedly included adjustments for interest synchronization in the revenue requirement, including in the Alt Reg Order where we expressly rejected the same claim that Ameritech presented in this proceeding.

ii. Pension Settlement Gains

Staff witness Hathhorn disallowed $23,650,000 in Corporate Operations Expense to reflect a normalized level of pension settlement gains in the test year. (Staff Ex. 20.0, Schedule 20.01, p. 1.) Pension settlement gains are a recognition of the difference between actual pension payments to participants and a value determined by the Financial Accounting Standards Board. Staff witness Hathhorn's adjustment to pension settlement gains was calculated from two components: (1) a normalized pension settlement gain, and (2) a five-year amortization of abnormal gains.

GCI proposed a similar adjustment as Staff's, however differences in methodology concerning the inclusion of curtailment losses lead to different final adjustments. (GCI Ex. 6.1, Sched. E-3, E-15, and E-18.) GCI proposed an additional pension settlement gain adjustment for year 2000 activity, which Staff opposed as outside the test year. AI opposed both Staff's and GCI's adjustments on the basis the gains were prior period events.

iii. Directory Revenue

Staff witness Everson recommended that Ameritech's Directory Revenue be increased by $126,000,000 ($75 million directory contract + $51 million imputed directory revenue) using the methodology applied in the Alt Reg Order. Directory Revenue is the profit Ameritech Illinois has received from publishing and selling advertising Illinois directories. (GCI Ex. 6.0 at 24, lines 16-19.) GCI proposed a similar adjustment to that of Staff's, since the Commission found that an imputation was necessary for the purpose of establishing an appropriate revenue requirement in the last Alt. Reg. Order, Docket No. 92-0448/93-0239 (consol.), at 101-03. Ameritech opposed the imputation and proposed to adjust Directory Revenue downward to represent the expiration of a contract with Ameritech Publishing, Inc. d/b/a Ameritech Advertising Services.

iv. Incentive Compensation Plan

Staff witness Everson recommended that Ameritech's expenses be reduced by $16,117,000 to account for the expensed portion of the management incentive compensation plan that does not benefit the ratepayer. (Staff Ex. 21.0, Sched. 21.02, p. 1.) Ameritech claimed that the Company's incentive compensation plan is a prudent business expense. Staff's adjustment was consistent with the Commission's actions in adopting previous exclusion adjustments for incentive compensation. (Illinois Power Company, Docket No. 93-0183, and in MidAmerican Energy Company, Docket No. 99-0534.)

v. Social and Service Club Dues

Staff witness Everson recommended that the revenue requirement be reduced $266,994 for fees and dues attributed to Social and Service Clubs. (Staff Ex. 21.0, Sched. 21.03 at 1.) Ameritech claimed that these types of dues and membership fees are normal, prudent operating expenses and therefore should be included in the determination of the Company's revenue requirement. (Ameritech Ex. 7.2 at 26.) The Commission has previously disallowed dues paid to similar community organizations.

vi. External Relations

Staff witness Everson recommended that $20,387,000 associated with external relations be removed from the revenue requirement. (Staff Ex. 30.0, Sched. 30.02, p. 2; also Staff Ex. 21.0, Sched. 21.04.)

Ameritech identified its external relations as non-product-related corporate image advertising, costs associated with maintaining relations with government, regulators, other companies and the general public. (Ameritech Ex. 7.1 at 23.) Such costs have been disallowed from rate recovery under PUA Section 9-225(1)(c) and 83 Ill. Adm. Code 295.10(a).

GCI recommended an adjustment of $6.807 million to remove the expense associated with non-product, corporate-image advertising identified in data request GCI/City 5.36). (GCI /City Ex. 6.0, p. 35.) GCI asserted that corporate-image advertising is of little or no benefit to Illinois jurisdictional ratepayers because its purpose is to promote the image of Ameritech, and now SBC.

vii. FAS 71 Adjustment

Staff witness Marshall recommended the Commission remove $107,906,000 from Ameritech's Depreciation and Amortization due to FAS 71 corrections. Financial Accounting Standards Board Statement 71 ("FAS 71") is an accounting rule, which allows a regulated company to account for transactions on its financial records in the same way it does on its regulated books under certain conditions. The Commission previously addressed the depreciation reserve deficiency in the last Alt. Reg. Order, Docket No. 92-0448/93-0239 (consol.), finding that no amortization of a depreciation reserve deficiency was appropriate for inclusion in an alternative regulatory plan. Staff proposed that the FAS 71 adjustment be treated as a one-time event occurring outside of the test year.

GCI also recommended the disallowance of FAS 71 amortization expense since there is no annual amortization related to FAS 71 occurring on either Ameritech's financial reporting books or its books used for FCC purposes. GCI asserted that accordingly, no such amount should be recognized for the sole purpose of intrastate ratemaking.

viii. Depreciation and Amortization

Staff recommended a Total Depreciation and Amortization expense of $558,680,782. (Staff Brief Appendix B, page 1 line 6.) Ameritech's Adjusted Intrastate Depreciation Expense is $607,758,155, resulting in a negative adjustment of Ameritech's Adjusted Intrastate Depreciation Expense of $49,077,373. (Ameritech Ex. 7.3, Sched. 4, and Staff Brief Appendix B, page 1.)

Staff's Total Depreciation and Amortization adjustment is comprised of three parts: (1) adjustment for overdepreciated accounts (Staff Ex. 24.0 Sched. 24.1 line R); (2) adjustment for amortization of circuit equipment, (GCI Ex. 9.0 at 50); and (3) adjustment for amortization of other freedoms (GCI Ex. 9.0 at 52) ($101,656,920 + $11,242,000 + $32,126,000, respectively). This includes Staff's adoption of GCI witness Dunkel's adjustment of $11,242,000 for amortization of Circuit Equipment (GCI Ex. 9.0 at 50), and $32,126,000 for amortization of "other freedoms" (id. at 52).

GCI proposed that Ameritech's depreciation expense be adjusted to $382.4 million for 1999 test year purposes (GCI BOE, p.156). GCI asserted that its expert witness' testimony on depreciation was more credible than that of Ameritech's. One example of this is that GCI detected the $160.4 million error for which Ameritech revised its number. GCI also challenged Ameritech's inclusion of a reserve deficiency in its calculation of amortization expense. GCI's adjustment also accounted for using 1999 versus 1995 rates for certain plant life parameters.

While Ameritech admitted that there was an error in its depreciation expense calculation, as discussed above, its position remained that a review of its depreciation expense is beyond the purview of the Commission due to the depreciation freedom granted to Ameritech in the Alt Reg Order.

ix. Revenues Related to Ameritech's Failure to Meet Service Quality Standards

GCI recommended $29.579 million of foregone revenue be restored to the test year for the cumulative impact on the 1999 test year for Ameritech's failure to provide adequate service. (CUB IB, Schedule E-8). GCI argued that foregone revenue associated with Ameritech's failure to meet service quality standards is similar to a cost incurred by IBT associated with the failure to meet acceptable service quality standards, and should not be charged to customers. Ameritech objects to this adjustment, arguing that it imputes revenues that it did not in fact receive during 1999.

x. Asset Disposition Accruals

GCI recommended an adjustment to Ameritech's proposed removal of a $5.518 million credit to expense associated with "asset disposition accruals". GCI argued a more appropriate ratemaking treatment would be to amortize the credit over a similar period that the over-accruals were built up over, and therefore recommended a five year amortization period be utilized. Ameritech averred that GCI's five-year amortization of the amount improperly reflects prior period activities in the test year.

b. Uncontested Issues

F. i. Uncollectibles

Staff witness Voss proposed an uncollectible percentage of 1.67%. Ameritech agreed with Staff's uncollectible percentage of 1.67%, and with Staff's $18,685,000 correcting adjustment, but did not include all of the necessary correcting adjustments for uncollectibles in its operating statement on Ameritech Ex. 7.3, Sched. 1.

G. ii. Gross Receipts Taxes

Staff witness Voss proposed to remove both the expenses and revenues attributable to gross receipts taxes to prevent double billing of the ratepayer. (Staff Ex. 19.0, lines 167-78.) Additionally, Staff proposed that the 3% collection fee on municipal utility taxes not be included in the operating revenues required for the determination of rates. (Staff Ex. 19.0, lines 183-90.) Ameritech originally proposed to include both the revenues and expenses for certain gross receipts taxes in its operating statement. (Staff Ex. 5.0 at 16, lines 281-82.) AI later agreed with Staff's proposed adjustment to gross receipts taxes. (Ameritech Ex. 7.2 at 2-3.)

H. iii. Merger Planning and Implementation Costs

Staff witness Hathhorn disallowed Ameritech's pro forma adjustment for merger planning and implementation costs since analysis of such costs is more appropriate for the Commission's subsequent proceedings related to the 50% Net Merger-Related Savings condition from Docket No. 98-0555, Original Order dated September 23, 1999, at 262, finding 8. GCI recommended an adjustment identical to that of Staff's. Ameritech accepted the adjustment.

I. iv. Advertising—Sport Team Sponsorship

Staff and Ameritech agreed with the GCI proposal to remove $96,000 from advertising expense relating to sports team sponsorship. (Staff Ex. 21 at lines 141-145; Ameritech Ex. 7.1 at 6; and GCI Ex. 6.1, Sched. E-7.)

J.

K. v. Income Tax Expense Correction

GCI discussed in direct testimony the need for making an adjustment to reduce income tax expense in the Company's test year operating income statement on a total company basis (GCI Ex. 6.0). Ameritech accepted GCI's correction in rebuttal testimony (Ameritech Ex. 7.1, Schedules 1 and 3.)

c. Issues That Are Uncontested But Are Not Accepted

There were two issues that Ameritech neither explicitly disagreed with nor accepted.

L. i. Uncollectible Expenses for Intrastate Known Changes

Ameritech did not include the application of the 1.67% uncollectible percentage to its proposed revenue changes. (Staff Ex. 19.0 at lines 93-112 and Schedule 19.06, and Staff Initial Brief at 102 and Appendix A, p. 7.)

M. ii. Ameritech's Income Tax Expenses

Due to an "insert problem," the amounts for Federal Income Taxes and State and Local Income Taxes are inaccurate in column A on Ameritech Ex. 7.3, Sched. 1. (Tr. 1055-63, and Staff Initial Brief at 102-3.)

2. Rate Base Adjustments

AI witness Dominak presented AI's final proposed rate base in Additional Surrebuttal Testimony. (AI Ex. 7.3, Sched. 2.)

a. Contested Issues

i. Adjustment to Plant Under Construction

Staff witness Hathhorn excluded from rate base that portion of telephone plant under construction ("TPUC") generating Interest During Construction ("IDC") since such treatment is required under Section 9-214(d) of the PUA. (Staff Ex. 20.0, Sched. 20.02.) Ameritech, GCI, and

Staff agreed that an adjustment needed to be made to prevent the double recovery of IDC, however, the method of adjustment remained at issue.

ii. Incentive Compensation

Staff witness Everson recommended reducing the capitalized portion of Ameritech's incentive compensation for the same reasons stated above in the Revenue and Expense Adjustments section of this Order.

iii. Accumulated Deferred Income Taxes ("ADIT")

GCI recommended ADIT be adjusted related to its adjustment to uncollectibles expense. GCI argued that the ADIT debit balance of approximately $19 to $20 million for uncollectibles should be removed from rate base (Cub IB, Schedule E-17). Ameritech opposed the GCI adjustment because it stated only the tax effect of the $19 million adjustment to uncollectible expense would impact rate base.

b. Uncontested Issues

i. Materials and Supplies

GCI proposed an adjustment to increase rate base by $924,000 to reflect the current ongoing level of Materials and Supplies. Ameritech agreed with the adjustment in rebuttal testimony (Ameritech Ex. 7.1, at 8).

3. Cost of Capital

a. Capital Structure and Cost of Debt

AI's position

AI maintains that its target market-weighted capital structure should be used to calculate the overall cost of capital for revenue requirement purposes. AI asserts that AI's target market-weighted capital structure is that of its publicly traded peer group, which consists of 75.09% equity and 24.91% debt. (AI Ex. 1.1 at 111; AI Ex. 6.0 at 10, 38.)

AI claims that in today's more uncertain environment, the overall cost of capital should be determined using market weights. (AI IB at 134.) AI witness Dr. William Avera agrees that book values of the components of the capital structure are appropriate for traditional, original cost ratemaking. However, he suggests that since AI operates in the competitive sector, book values are no longer appropriate for capital structure measurement. (AI Ex. 8.1 at 9.)

AI estimated its cost of short-term debt at 5.81% and its cost of long-term debt at 7.91%. (AI Ex. 6.0 at 37-38, Schedules 11 and 13.) These costs were multiplied by the respective balances of short-term and long-term debt to arrive at AI's 6.71% cost of total debt estimate. (AI Ex. 6.0, Schedule 13.)

Staff's Position

Staff recommended using AI's book value capital structure for the year ended December 31, 1999 to determine the weighted average cost of capital in the event that the Commission re-initializes AI's rates. Staff's recommended capital structure is comprised of 22.03% short-term debt, 18.00% long-term debt, and 59.94% common equity. (Staff Ex. 11.0, Schedule 11.01.) Staff's recommended capital structure for AI is reasonable since the total debt ratio of 40.06% proposed is consistent with the Standard & Poor's benchmark of 42% debt and under for AA rated telecommunications companies. (Staff Ex. 11.0 at 8.)

Book values of the components of the capital structure are appropriate for traditional, original cost ratemaking. (Staff Ex. 11.0 at 6.) The Commission only uses original cost rate base when setting rate of return-based rates. Therefore, AI's book value capital structure should be used if the Commission uses rate base/rate of return ratemaking procedures to re-initialize AI's rates. (Staff RB at 77.)

Staff estimated that the appropriate balance of short-term debt to include in AI's capital structure was $671,284,205. (Staff Ex. 11.0 at 7.) This balance of short-term debt is the average balance for the period from June 1999 through June 2000, which is centered in time at December 31, 1999 (the measurement date for the other components of the capital structure). Staff testified that the appropriate cost of short-term debt was 6.61%, based on the current annual yield on thirty-day "AA nonfinancial" commercial paper. (Staff Ex. 11.0 at 9.)

Staff testified that the balance of long-term debt outstanding as of December 31, 1999 was $547,746,000 and its cost was 6.73%. (Staff Ex. 11.0 at 9-10, and Schedule 11.03.) The balance of common equity that

Staff recommended was $1,824,500,000, which the Company reported in its annual report to the Federal Communications Commission. (Staff Ex. 11.0 at 8.)

GCI's position

GCI used Staff's recommended capital structure and cost of short-term debt and long-term debt to calculate AI's revenue requirement. (GCI Ex. 6.0 at 14.)

Commission Analysis

Staff's estimates of AI's capital structure and costs of short-term and long-term debt are the most appropriate for establishing the proper rate of return in the context of original cost ratemaking. The Commission agrees that book value should be the basis for capital structure measurement to ensure consistency between rate base and capital structure.

b. Return on Common Equity

AI's Position

AI witness Dr. Roger Ibbotson performed a two-stage Discounted Cash Flow ("DCF") analysis and a risk premium (Capital Asset Pricing Model or "CAPM") analysis on a group of peer companies to estimate the cost of equity for AI. He estimated that the cost of equity for AI is within a range of 11.86% to 12.71%, based on the average cost of equity of its peer group. (AI Ex. 6.0 at 4.) Dr. Ibbotson did not make an explicit adjustment for flotation costs in his cost of equity analysis. (AI Ex. 6.0 at 37.)

Dr. Ibbotson formed his peer group by examining publicly traded telecommunications companies in the Standard & Poor's Compustat database. He excluded long-distance companies, companies not included in Value Line's Telecommunications Services sector, companies with less than 50% of their sales in SIC code 4813, and companies with less than two years of available data. (AI Ex. 6.0 at 12-13.) He concluded that AI was at least as risky as the proxy firms in the peer group due to AI's high capital intensity and operating leverage, and an alleged loss of regulatory protection and accelerating competition. (AI Ex. 6.0 at 14.)

Dr. Ibbotson used the quarterly version of a two-stage DCF model to estimate the cost of equity for each peer group company. The first stage covers the next five years, and the second stage covers the long-term, defined as years six and thereafter. (AI Ex. 6.0 at 19.) He used analysts' recent estimates of five-year growth in earnings per share published by IBES and Value Line for his first stage growth rate. For the second stage growth rate, Dr. Ibbotson used the historical long-term real growth in the economy and then added an estimate of long-term inflation to arrive at a nominal growth forecast of 7.4%. Dr. Ibbotson measured the historical long-term growth in the economy by computing the compound annual growth in real (adjusted for inflation) Gross Domestic Product ("GDP") for the period 1948 to 1999. He then added his 3.3% real GDP historical growth estimate to his 4.1% inflation forecast, which was based on his assessment of the long-term inflation rate implied in bond yields. (AI Ex. 6.0 at 21-22.)

Dr. Ibbotson averaged the dividend yield for each peer group company as of February 29, March 31, and April 28, 2000 to estimate the dividend yield for his DCF analysis. The three companies in his peer group that did not pay dividends were excluded from his DCF analysis. (AI Ex. 6.0 at 22-23.)

In his CAPM analysis, Dr. Ibbotson averaged the yield on twenty-year U.S. Treasury bonds for the three dates of February 29, March 31, and April 28, 2000 to estimate the risk-free rate. (AI Ex. 6.0 at 34.) For the equity risk premium, he calculated the difference between the historical arithmetic mean return on the overall stock market, as measured by the total return on the Standard & Poor's 500 Index, and the historical average yield return on long-term U. S. Treasury bonds, measured over the period of 1926 to 1999. (Id.) To estimate beta, Dr. Ibbotson averaged the three-year IBES and two-year Bloomberg beta estimates for each company in the peer group. Dr. Ibbotson opined that the last five years might not accurately represent AI's current risk given the rapid pace of change in the telecommunications industry and the dramatic events in recent years. Therefore, he thought that beta should be estimated over a shorter period. (AI Ex. 6.0 at 34-35.) Using the methodologies described above, Dr. Ibbotson estimated the risk-free rate, market risk premium and beta equaled 6.31%, 8.07% and 0.79, respectively.

Dr. Ibbotson's estimate of the weighted average cost of capital for AI ranges from 10.58% to 11.21%. He arrived at this estimate by applying AI's target market capital structure to his estimates of AI's cost of debt and his peer group cost of equity. (AI Ex. 6.0 at 40.)

Staff's Position

Staff witness Alan Pregozen also measured the investor-required rate of return on common equity for AI with the DCF and risk premium models. He performed the DCF analysis under constant-growth and two-stage non-constant growth scenarios. His risk premium analysis utilized the capital asset pricing model ("CAPM"). Since AI's stock is not market-traded, he applied those models to a sample of five telecommunications companies comparable to AI. (Staff Ex. 11.0 at 10-31.)

To form his telecommunications sample, Mr. Pregozen eliminated several of the companies in Dr. Ibbotson's peer group because of recent developments and lack of necessary data. This screening reduced the number of companies in the sample to four: Bell South Corporation, CenturyTel Inc., SBC Communications Inc., and Verizon Communications. To find additional companies comparable to AI, Mr. Pregozen examined the revenue mix of telecommunications industry companies and eliminated those with less than fifty percent of revenue derived from local telephone operations, including access revenues. He also eliminated those companies that lacked the data necessary to conduct the DCF and CAPM analyses. One additional telecommunications company, Hickory Tech Corporation, met those criteria. (Staff Ex. 11.0 at 11; Tr. 2241-2243.)

Under the constant growth DCF scenario, the firm's dividends (or earnings) are expected to grow at a constant rate. For his constant growth DCF scenario, Mr. Pregozen averaged the projected earnings growth rates provided by IBES and Zacks for each of the telecommunications companies in his sample. (Staff Ex. 11.0 at 13-14.) He measured the current stock price of each company in his sample using closing market prices from September 6, 2000. Current stock prices are more appropriate than historical stock prices because the former reflect all information that is available and relevant to the market. (Staff Ex. 11.0 at 14-15.) The expected growth rate was applied to the last four dividends paid to estimate the next four expected quarterly dividends. (Staff Ex. 11.0 at 15.) Mr. Pregozen's DCF analysis under the constant growth scenario produced a 15.76% estimate of the required rate of return on common equity for the telecommunications sample. (Staff Ex. 11.0 at 16.)

Under the non-constant growth DCF scenario, dividends are expected to grow at different rates during different future periods. For the non-constant growth scenario, Mr. Pregozen used the same growth rate estimates employed in the constant growth scenario for the short-term growth stage over the first five years. The second, or long-term growth stage, was assumed to continue into perpetuity. Since company-specific growth rates are unavailable, Mr. Pregozen used long-term economic growth for the second stage growth rate, which he measured by computing the compound forecasted annual growth in nominal Gross Domestic Product for the period from 2000 through 2019. (Staff Ex. 11.0 at 15-17.) He used the same stock prices and dividends that were used in his constant growth scenario. (Staff Ex. 11.0 at 17.) The DCF cost of equity equaled 8.30% under the two-stage non-constant growth scenario. (Staff Ex. 11.0 at 18.)

Mr. Pregozen used forecasted growth in nominal GDP as his second stage growth rate because it incorporated inflation expectations into the projected values that he used to estimate growth over the long-term. In contrast, Dr. Ibbotson used historical growth in real GDP plus his inflation forecast as his second stage growth rate. Mr. Pregozen testified that Dr. Ibbotson's inflation estimate is much higher than the forecasts of WEFA and the *Survey of Professional Forecasters*. When combined with his GDP estimate it produces a nominal GDP forecast that is in excess of the yields on U.S. Treasury bonds of all maturities. This does not make sense, since Treasury bond yields should incorporate elements, GDP growth and inflation, plus a risk premium. (Staff Ex. 11.0 at 18.)

Mr. Pregozen's CAPM analysis utilized an adjusted beta of 0.85, estimated over a sixty-month period. (Staff Ex. 11.0 at 20-23.) He testified that a beta estimate using five years of monthly data is more appropriate than a shorter period. Mr. Pregozen stated that the rapid pace of technological change and the advent of competition in the telecommunications industry are not recent developments. The Commission altered the regulatory structure of Ameritech I Docket 92-0448 to allow the Company and the ratepayers to transition themselves to a more competitive telecommunications marketplace. Hence, use of five years of data to calculate beta is within the era of rapid structural and technological change in the telecommunications industry. In addition, a longer period incorporates more data points and is less susceptible to the wide variations as manifest in as comparison of the two-year and three-year beta estimates that Dr. Ibbotson employed. Moreover, use of monthly data mitigates the effect of non-simultaneous closing prices. (Staff Ex. 11.0 at 22-23.)

To estimate the risk-free rate, Mr. Pregozen used the yield on thirty-year U.S. Treasury bonds because the WEFA and *Survey of Professional Forecasters* estimates of inflation and real GDP expectations indicated that the thirty-year U.S. Treasury bond currently more closely approximates the long-term risk free rate. (Staff Ex. 11.0 at 27-28.) He estimated the expected rate of return on the market by conducting a DCF analysis on the firms composing the Standard & Poor's 500 Index. (Staff Ex. 11.0 at 28.) He then subtracted his estimate of the risk-free rate from this market return to determine the risk premium, multiplied the risk premium by his beta estimate, and added the result to his estimate of the risk-free rate. This resulted in a 14.62% estimate of the required rate of return on common equity for Mr. Pregozen's sample of telecommunications companies. (Staff Ex. 11.0 at 28.)

Based on his DCF and CAPM analyses, Mr. Pregozen concluded that the investor required rate of return for AI's common equity ranged from 11.80% to 14.40%, with a midpoint estimate of 13.10%. He formed this range by: 1) averaging the DCF-derived estimates of the required rate of return on common equity, or 12.03% and rounding to the nearest tenth of a percent, or 12.0%; 2) rounding the risk premium estimate of the required rate of return on common equity (14.62%) to the nearest tenth of a percent, or 14.6%; and 3) adjusting downward both ends of the range by 20 basis points to reflect the less risky position of AI relative to the telecommunications sample as a whole. (Staff Ex. 11.0 at 29-30; Staff RB at 79.) Mr. Pregozen testified that no adjustment for issuance costs should be made to the investor-required rate of return on common equity for AI. (Staff Ex. 11.0 at 30-31.)

Hence, Staff's recommended overall cost of capital for AI for revenue requirement purposes in the event that the Commission orders rate re-initialization in this proceeding ranges from 9.74% to 11.30%, with a midpoint estimate of 10.52%. The midpoint estimate reflects a cost of equity of 13.10%. (Staff Ex. 11.0 at 31.)

GCI's Position

GCI witness Smith utilized the low end of Staff's cost of equity range, 11.80%. He claimed that 11.80% appeared reasonable in comparison to the cost rate for common equity for intrastate telephone operations in other recent cases in which he participated as a witness. (GCI Ex. 6.2 at 54.) Mr. Smith did not conduct an independent analysis of the company's intrastate cost of equity for this proceeding. His recommendation for the overall cost of capital for AI for revenue requirement purposes is the low end of Staff's range, 9.74%. (GCI Ex. 6.0 at 16.)

Commission Analysis

Mr. Pregozen's estimate of AI's cost of common equity is the most appropriate for evaluating AI's rate of return and reinitializing rates. To estimate AI's cost of common equity, Mr. Pregozen used theoretically correct models that the Commission has accepted for years. In addition, Mr. Pregozen fully explained the reasons for his decisions including use of alternative growth rate scenarios in his DCF analysis, equally weighting the constant and non-constant growth scenario estimates and use of a five-year beta. Further, Mr. Pregozen exercised sound judgment. Although Dr. Ibbotson estimated a lower cost of common equity using the same models as Mr. Pregozen, Dr. Ibbotson applied that cost to a market value-based capital structure that is inappropriate for establishing the cost of capital in the context of original cost, rate of return rate making. Moreover, that market value-based capital structure is unnecessarily expensive given the risks associated with noncompetitive telecommunications services.

In summary, the Commission finds 13.10% is the most reasonable estimate of AI's cost of common equity. Staff's 13.10% midpoint cost of equity estimate is the appropriate value to use as it encompasses both of the cost of equity methodologies the Commission has long recognized as valid. The low end of Staff's recommended cost of equity range is based wholly on the average DCF analyses under constant growth and non-constant growth scenarios. The results of the CAPM analysis are not included. The Commission has consistently authorized rates of return on equity that reflected both CAPM and DCF analyses. (Staff IB at 117) The Commission has also previously concluded that parties must provide a complete and detailed explanation when exercising judgment, an explanation that is lacking in GCI witness Smith's recommendation. (Order, Docket No. 92-0448/93-0237, October 11, 1994 at 174)

Combining the 13.1% cost of common equity with our conclusions regarding AI's capital structure and costs of debt results in a 10.52% cost of capital as shown in the table below:

Component	Percent of Total Capital	Cost	Weighted Cost
Short term Debt	22.06%	6.61%	1.46%
Long-term Debt	18.00%	6.73%	1.21%
Common Equity	59.94%	13.10%	7.85%
Total	100.00%		10.52%

4. Commission Conclusion

Even though the Staff and GCI calculated, the use of the revenue requirement, operating revenue reductions of $837,576,000 and $956,000,000, respectively, from AI's current rates, as stated in Section III.10, we find that the Plan constitutes an appropriate form of regulation, and we are not rendering any decisions on the revenue requirement or any adjustments to the revenue requirement.

VII. SERVICE QUALITY – GOING FORWARD

Ameritech Penalties

In it Brief on Exceptions, Ameritech argues that the HEPO imposed increased penalties on each new service quality measure when, in its belief, there is no evidence that increased penalties are necessary to assure compliance with those measures. (Ameritech BOE, page 29.) Ameritech's argument is flawed in several ways. First, the new service quality measurements are just that, new, and have never been assigned a penalty, so there is no basis for Ameritech's argument that the penalties were increased when, in fact, they never existed. Second, in its attempt to prove the adequacy of its quality of service, Ameritech cites to its performance for only one standard, repair repeat reports. (Id.) If, as Ameritech witness Hudzik admitted, adequate service in one area does not excuse bad performance in another (Tr. 1683; see, also, Staff Reply Brief, page 42), then, equally, good performance for one benchmark cannot establish performance for all others. Furthermore, Ameritech states that it promptly devoted the necessary resources necessary to assure compliance with the Commission's new benchmarks (effective October 2000) for business and repair office times. (Id.) Ameritech may have devoted the resources, but the effective date of the rule was September 1, 2000, not October, and as reported in the Company's annual answer time report, Ameritech was not in compliance until November. The penalties, as amended by Staff in its Brief on Exceptions, for the new service quality standards are just and reasonable, and are necessary to safeguard the public's interest and insure service quality for Illinois consumers.

Ameritech also states that its service performance since 1999 demonstrates that the existing penalties (including the $30 million merger penalty) were adequate to maintain reasonable performance. (Ameritech BOE, page 30.) To the contrary, Ameritech's OOS>24 repair performance declined to an all time low of 37% in September 2000, which provides tangible proof that the

$30 million penalty (in addition to the Q Factor) was insufficient to ensure adequate performance. Section 13-506.1 requires the company to at least maintain the quality and availability of service, and not merely to maintain what Ameritech would have pass for a ‘reasonable performance.’

Increasing the penalties (where penalties previously existed), and providing matching penalties for new performance measures, is clearly within the Commission’s authority pursuant to Section 13-506.1. If Ameritech believes the lower level of penalties provide adequate incentive to meet the benchmarks, then the newer penalties certainly will also accomplish that task. And, if, as the Ameritech currently contends, it will be able to meet the benchmarks, Ameritech will not incur a penalty in any case. If hope were the appropriate currency, then the Commission could hope that would be the case. But, hope does not protect customers. Staff believes the higher penalties will protect them.

Ameritech supports the HEPO’s proposal that it be allowed to deduct the customer credits from any annual penalties. (Ameritech BOE, page 31; HEPO, page 140.) Staff opposed this netting out of consumer compensation in its BOE, at pages 13 – 14. Staff believes that the HEPO, and Ameritech’s support for it, are contrary to the Commission’s decision in Docket No 92-0448/93-0239, not to allow Ameritech to be able to earn back price cap adjustments when it met the benchmark for the year following the failure.

Staff also disagrees with Ameritech’s recommendation that any service quality measure for which consumer compensation is provided should not carry a penalty and so should be eliminated from the Alternative Regulation Plan on the basis that consumers will be adequately compensated, and that additional remedies would be excessive. (Ameritech BOE, page 33.) Ameritech's reasoning evidences no regard for the separate and distinct rationale for compensation paid directly to harmed customers, as opposed to performance penalties paid into a general fund. The point is to move toward compensation for what the customers have suffered, and not some measure of the partial dollar value of monthly service. The latter measures the revenue value to Ameritech, not to the customers. The insignificant one-time $19 credit that Ameritech has been providing to consumers fails as compensation compared to the one month's recurring charges plus the additional $20 per day for extended delays provided for in Section 13-712 of HB 2900. There is no tangible evidence in the record that Ameritech will maintain its infrastructure or workforce and the 2000 service quality fiasco will not repeat itself. Maintaining the service quality standards benchmarks, penalties, and consumer compensation defined in Section 13-712 of HB 2900 will provide the incentives for Ameritech to maintain service at the level to serve the public interest. The Commission should reject Ameritech's exceptions regarding penalties and incorporate Staff's exceptions, as set forth in Staff's BOE.

Missed Repair Commitments

Ameritech's Brief on Exceptions challenges the HEPO's reasoning for accepting Staff's proposed benchmark for Missed Repair Commitments. Ameritech opines that the HEPO's reasoning is inconsistent in that the HEPO based some benchmarks on five years of performance data, but based this particular benchmark on two years of data. (Ameritech BOE, pages 34 - 35.) Ameritech, perhaps, missed the HEPO's stated preference to "establish benchmarks on a case-by-base basis for each measured adopted, as a general proposition, we believe that using five years…" (HEPO, Pages 112 –113; C. Developing Benchmarks, Commission Analysis and Conclusion.) There is no statutory requirement that mandates the use of a five-year average. Staff is still of the belief that the method of establishing benchmarks that was approved by the Commission in Docket No. 92-0448/93-0239 serves in the public's interest. (Staff Ex. 23.0, pages 21 - 22.)

Ameritech also takes issue with Staff's proposal of the benchmark in its reply brief. (Ameritech BOE, page 35.) Ameritech provided Staff with the necessary information to calculate a benchmark only in its Supplemental Surrebuttal Testimony of Thomas J. O'Brien – the Company's *fifth* round of testimony (compared to the two rounds allotted to Staff). (Ameritech Ex. 3.43.) Staff provided the proposed standard at the first available opportunity.

Ameritech also objects to the adoption of Staff's more stringent benchmark of 6.4% versus 9.58% as proposed by Ameritech. (Ameritech BOE, page 35.) Ameritech challenges the HEPO on the ground that the measure was based on two years of data, and not five. Consequently, Ameritech argues, the measure does not take into consideration year-to-year and seasonal variations in performance. (Id.) There is no statutory requirement for the Commission to consider year-to-year and seasonal variations; there is no requirement that a five-year period must be used. As noted many times in this proceeding the

Commission was satisfied with a two-year performance period for setting benchmarks in Docket No. 92-0448/93-0239.

It is quite possible that performance in a particular year may be clearly undesirable to employ to capture a benchmark that prevents the degradation of service. For example, as even Ameritech admitted, statistics for OOS>24 for the year 2000 reveal Company performance of such an atrocious level that they should not be used to capture a true variation; use of the data would improperly skew performance measurement downward. The data for missed repair commitments over the five-year period proposed by Ameritech seem to show the same atypical performance variation. Ameritech's performance in 1995 was measured at 14.39%. In contrast, the Company's performance in 1998 was 6.70%, and for 1999 was 6.35%. (Ameritech BOE, page 36.) The variation is greater than 100%; this reflects a difference other than 'seasonal' or normal year-to-year variation; use of that data would improperly skew performance measurement.

Finally, Ameritech attacked Staff's definition of Missed Repair Commitments and accused Staff of a "bait and switch." (Ameritech BOE, page 37.) There was no such intent on Staff's behalf. Staff was attempting to explicitly define the standard to avoid the possibility of misinterpretation or misunderstanding. However, after considering Ameritech's comments, Staff agrees that the purpose of the measure is intended to measure reliability, rather than speed. Staff withdraws its recommendation to add the phrase, "within the time committed and within 24 hours." However, the Commission should reject

Ameritech's exception and retain Staff's proposed benchmark, with the revised definition. Staff recommends the following language to be included in the HEPO at pages 122-123:

Commission Analysis and Conclusion

7. Proposed: Missed Repair Commitments
(New) (No Benchmark established)
Supported by: AI, Staff, and GCI/City

~~Ameritech Illinois concurs with Staff's proposed measure and, on the basis of its historical performance for the years 1996-99, recommends a benchmark of 9.58% for Missed Repair Commitments (Field Visit). Staff contends that "Missed Installation Commitments" should be defined as installation or transfer of plain old telephone (POTS) service, meaning no vertical services, and include both field and non field visits, with the completion of work at a committed (field visit not required) or at an appointed (field visit required) time. Staff Reply Brief at 57).~~ According to Staff, AI evidence provides historical data for Missed Installation Appointments that includes field and non-field visits and excludes vertical services. On the basis of this data for the 1998 and 1999 historical period, Staff recommends a benchmark of 6.2% (Staff Reply Brief at 58.) Staff accepts AI's definition of "Missed Repair Commitments" as a measure of whether a repair has been completed on time and including both field and non-field visits. Once again, based on historical data for the years 1998-1999 Staff recommends a benchmark of 6.4%.

Calls Answered

Ameritech states that it may be useful to define Calls Answered and then correctly notes that Calls Answered or Calls Abandoned are basically interchangeable measures. (Ameritech BOE, page 37.) Ameritech also correctly states that in Docket No. 98-0453, the Commission declined to implement an Abandon Rate. (Id.) However, Ameritech fails to note that in that same docket, the Commission did not foreclose the use of a call abandon rate. In fact, the Commission explicitly required all companies, including Ameritech, to report their Abandon Rate to the Chief Clerk annually. This clearly shows that the Commission believes that the abandon rate has utility in measuring telecommunications service.

Ameritech also accuses Staff of changing its position from supporting an answering time measure to returning to a call abandon measure. This is not the case, although Staff understands that this might appear to be true. Staff's rebuttal testimony did not present a change of position. Rather, there was an error in terminology that was not caught. (Staff Ex. 23.0, page 15.) (A statement in the testimony shows that Staff did not change its position, "will provide the Staff with the information needed to compute the abandon rate…" (Id.)) A measure for answering time of 80% within 20 seconds or 60 seconds will not provide Staff with the necessary information to compute the call Abandon Rate. Requiring a standard and benchmark for Calls Answered, in addition to the 60 second answer time, will give the Commission the tools to ascertain whether or not Ameritech is providing good customer service and is in the public's interest.

Ameritech's criticism that Staff has not given the Commission any basis for considering a standard for Calls Answered is erroneous. (Id.) Staff provided evidence in its Direct Testimony that there is a direct correlation between the answer time and the abandon rate. (Staff Ex. 9.0, page 25, and Attachment No.

7.) The Commission should reject Ameritech's exception and retain Staff's proposed standard and benchmark, as described in Staff's BOE at page 23.

Installation Repeat Reports

Ameritech's reasoning that customers are more sensitive to repeat repairs than they are to instances of repeat installation visits is puzzling to Staff. (Ameritech BOE, page 39.) The only real differentiation seems to be that Ameritech has already taken money from customers in need of repair services, but not from those not-yet-quite-customers experiencing installation problems. Theoretically, person A could be a customer for a single hour (or less) and would be eligible for compensation. Person B, who would have been a customer but for Ameritech's failure to properly install, would not be eligible for compensation. And, the latter would be true even if installation failed a single minute before it was supposed to occur.

Ameritech's reasoning that a new customer is more tolerant of a repeat visit than an existing customer is not persuasive. Those without telephone service for long periods of time, with no opportunity to switch to another carrier, suffer the same consequences, whether the lack of service is due to repair or installation failure. (See, Staff Brief, pages 76 – 77; Staff Reply Brief, pages 59 – 60.) The Commission should reject Ameritech's exception and retain Staff's Installation Repeat Report standard.

Staff believes that the Installation Repeat Reports and Repair Repeat Reports should be separate, but that the HEPO and Ameritech err in dividing the assigned penalty between the two measures. Each measure should carry a full penalty amount to provide the same incentives for service quality performance to the Company provided by the other benchmarks. No justification was provided for differentiating this penalty from those imposed on other performance measures.

Based on the arguments shown above, Staff recommends the following charges to the HEPO on Page 119.

> Commission Analysis and Conclusion
> **Adopted: Measure No. 5 Repeat Trouble Rate.**
> **Benchmark – Installation (16.90%) Repair (13.92%)**
>
> We adopt Staff's proposal to include in the Plan a ~~combined~~ repeat trouble measure reflecting both installation and repair repeat rates. Because these measures are incompatible, ~~however,~~ we cannot blend the two benchmarks or penalties ~~in the manner suggested by Staff. Instead,~~ and ~~we~~ will set separate benchmarks and ~~we will divide the assigned~~ will assign separate penalties. ~~a penalty equally between them.~~ We adopt Ameritech Illinois' proposed benchmark of 13.92% for Repeat Trouble Rate (Repair), based on 1994-99 data. We adopt Ameritech Illinois' proposed benchmark of 16.90% for Repeat Trouble Rate (Installation) based on data from 1996-99.
>
> We reject GCI's proposed benchmarks. Once again, we remain unconvinced of the propriety of setting benchmarks based on internal targets especially where they are inconsistent with actual operating performance. In any event we are persuaded that, for Repeat Trouble Rate (Installation), GCI has relied upon the wrong internal target.

Alternative Telephone Service

In its BOE Staff briefly discussed the effects Section 13-712 of HB 2900 would have on the HEPO. Staff noted that the new legislation would require –

where the HEPO did not -- Ameritech to provide alternative telephone service for the Company's failures to meet both the OOS>24 and Installation within 5 days standards. (Staff BOE, Exception 22, pages 37 – 38.) Unfortunately, the alternative language provided by Staff does not fully articulate Staff's interpretation of Section 13-712. The provisions in the legislation set forth the *minimum* levels of remedies required. Therefore, the Commission may adopt stricter requirements. Based on the poor quality of service provided by Ameritech, coupled with the support of Staff's testimony and arguments (See, Staff Exs. 9.0 and 23.0; Staff Brief, pages 73 - 79; Staff Reply Brief, pages 53 - 55) in the record, Staff believes that the consumer compensation and alternative telephone service should be strengthened beyond the minimum levels provided by the Legislature. Staff recommends that the HEPO be revised at page 137, as follows:

> ~~Any one of the incentive and customer compensation schemes we reviewed, however, would effectively absorb the penalties through administrative costs (which in fairness should be counted). Further, these proposals set out a number of schemes in a general fashion without sufficient explanation of the details for implementation or the cost and effort involved. For example, the record gives no tally of the total financial cost and administrative tasks associated with a cellular loan program or the abuse potential. It is one thing to propose what appears to be an attractive option. It is an entirely different thing to substantiate the inner workings, the costs, efficiency, potential abuse and the legal pitfalls of such a program.~~
>
> ~~In our view, as with most things, the simpler the better for all concerned. We recognize and appreciate that Staff has set out a number of goals, all of which it attempts to satisfy through its proposal. The objective, however, is not to create the perfect penalty to fit each and every conceivable situation. To the contrary, the objective is to set~~

~~a reasonable penalty for the infraction that is direct, meaningful to both the customer and the Company, easily administered and in keeping with sound legal principles. In our view, penalties gain no value from being complicated – that would just engender a new set of frustrations for the public and create a new set of obligations on the Company.~~

<u>We believe that the General Assembly has spoken to Staff's and GCI's "cellular loaner proposal" in a manner which requires the adoption of a requirement that Ameritech offer to lend customers an alternative telephone service under certain circumstances where its failure to install or repair service or missed commitments is sufficiently prolonged. The General Assembly has directed that, at a minimum, carriers failing to install basic residential service within ten days of a request, or within five days of a customer's requested installation date or missed repair and installation commitments, must offer the affected customer the option of an alternative telephone service, or a $20 per day credit. The minimum set for the Company's failure to repair service is that, for repair effected beyond the initial 120-hour period the carrier shall also providing either alternative telephone service or an additional credit of $20 per day, at the customer's option. Moreover, we find that Staff's proposals for the provision of alternative telephone service should be adopted.</u>

<u>Therefore, we shall require Ameritech to offer such compensation as proposed by Staff. Ameritech is required to offer its customers the options of alternative telephone service or an additional credit of $20 per day for:</u>

- <u>Service installations beyond 5 days;</u>
- <u>OOS>24 hours;</u>
- <u>Missed Repair Commitments; and</u>
- <u>Missed Installation Commitments</u>

Installation Within 5 Days – Vertical Services

Regarding the Installation within 5 days standard, Ameritech stated that it "has, without question, met this benchmark consistent over the life of the Plan." (Ameritech BOE, pages 30 – 31.) However, Staff established that Ameritech's position is correct only if its performance is artificially inflated by the inclusion of vertical services in its installation statistics. In fact, Ameritech improperly applied installation statistics throughout the life of the Plan -- and it was the only major telecommunications carrier in Illinois incorporating vertical services into the installation calculation. (Staff Brief, pages 62 – 63.) Staff also showed that Ameritech's own tariff pages filed with the Commission clearly denote vertical services to be optional services. (Staff Reply Brief, pages 43 –44.) The installation of these services thus cannot reasonably be considered "regular service installations." Consequently, the $29 million reduction was fully "earned" by Ameritech for its dismal regular service installation performance. Moreover, it is necessary to immediately implement the 95.44% standard adopted by the HEPO in order to protect the public from continued substandard performance by Ameritech. Phasing in the standard over a number of years, as the HEPO currently contemplates, merely rewards Ameritech for inventing its own definition of "regular service installation," and encourages other creative definitions in the future. Accordingly, its Exceptions in this regard must be rejected.

WHEREFORE, the Staff of the Illinois Commerce Commission respectfully requests that its recommendations be adopted in their entirety consistent with the arguments set forth herein and in Staff's Brief on Exceptions.

Respectfully submitted

Matthew L. Harvey
David L. Nixon
Sean R. Brady
Illinois Commerce Commission

Office of General Counsel
160 North LaSalle Street
Suite C-800
Chicago, Illinois 60601
312 / 793-2877

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Counsel for the Staff of the
Illinois Commerce Commission